F I S C A L   I M P A C T   R E P O R T

SPONSOR Egolf **ORIGINAL DATE** 1/20/15
LAST UPDATED **HB** 28

SHORT TITLE Small Business Development Fund Act **SB**

ANALYST Clark

APPROPRIATION (dollars in thousands)

Appropriation		Recurring or Nonrecurring	Fund Affected
FY15	**FY16**		
	Up to ($100,000.0)	Nonrecurring	Severance Tax Permanent Fund
	Up to $100,000.0	Nonrecurring	Small Business Development Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Nonrecurring	Fund Affected
FY15	**FY16**	**FY17**		
	($7,500.0)*	($8,062.0)*	Recurring	Severance Tax Permanent Fund
	($352.0)*	($379.0)*	Recurring	General Fund
	Indeterminate		Recurring	Small Business Development Fund

(Parenthesis ( ) Indicate Revenue Decreases)

*This is the projected opportunity cost. See Fiscal Implications.

SOURCES OF INFORMATION
LFC Files

Responses Received From
State Investment Council (SIC)
Attorney General's Office (AGO)
Economic Development Department (EDD)
New Mexico Finance Authority (NMFA)

SUMMARY

Synopsis of Bill

House Bill 28 is the Small Business Development Fund Act; it creates the Small Business Development Fund (Fund), a board of directors with staggered terms, and allows up to $100 million from the severance tax permanent fund to be invested in the Small Business Development Fund to participate in loans with community banks for economic development projects. Up to $5 million of that investment may be used to establish and operate the Fund. The remainder shall be used to fund the loan program as set forth by the act.

"Economic development project" is defined as land, buildings, improvements, machinery and equipment, operating capital and other personal property for use in providing:

(1) assistance to rural or underserved areas designed to increase business activity;
(2) retention and expansion of existing business enterprises;
(3) attraction of new business enterprises; or
(4) creation and promotion of an environment suitable for the support of start-up and emerging business enterprises within the state.

The Fund shall not be subject to the supervision or control of any other board, bureau, department, or agency of the state except as specifically provided in this act. The Fund would be governed by the Small Business Development Fund Board (Board), consisting of seven members, three appointed by the governor and three by the Legislative Council. All members shall be residents of the state with expertise in banking, lending, and finances. The six members shall elect a seventh person, with similar expertise, to serve as chair. The Board shall appoint and prescribe the duties of an executive director and other officers as necessary, all of whom will not be subject to the Personnel Act.

The bill provides the Board with the necessary powers to operate the Fund, including the ability to make and renegotiate loans, prosecute and enforce judgments, and invest money of the Fund not required for immediate use.

All loans made by the Fund shall be to a New Mexico resident or business; be in the form of loan participations of up to 49 percent financing with community banks; have rates equal to those of the participating bank unless a lower rate may legally be charged; provide that the Fund and the bank have equal security interest; if the loan is for real estate, have a maximum term of 25 years; if the loan is for personal property or operating capital, have a maximum term of 10 years; and be for an economic development project.

FISCAL IMPLICATIONS

The provision for an investment of up to $100 million contained in this bill is a nonrecurring expense to the severance tax permanent fund (STPF). Up to $5 million may be used for start-up and operational costs, but there may also be ongoing operational costs not contemplated for the Fund and its infrastructure.

Analysis from the State Investment Council (SIC) notes the bill does not provide a return of capital mechanism from the Fund to the STPF, leading to the logical assumption the funds are never intended to produce an investment return for the benefit of the STPF. The bill provides that the Fund would not be operated "for the purpose of making a profit" and that the Fund would make loans at rates charged by a community bank, or lower if allowed by law. As a result, SIC projects investment returns of zero or less versus the otherwise targeted STPF rate of return of 7.5 percent.

SIC includes the following detailed fiscal implications in its analysis.

> As of November 30, 2014, the STPF is valued at $4.723 billion. Therefore, the $100 million the bill envisions obtaining from the STPF would be approximately 2.1 percent of the STPF.
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> The 10-year impact of a 0 percent return (versus the current 7.5 percent target) on $100 million is $106 million dollars less in investment return to the corpus over a decade, not including the original $100 million investment outlay. In addition, lost opportunity cost to the STPF associated with a 0 percent return would further trickle down in the form of decreased distributions to the general fund.

STPF Annual Return Assumption: **7.5%**

FY	Investment in development fund ($millions)	Cumulative portfolio impact ($millions)
2016	$100.00	$107.5
2017	$0.00	$115.6
2018	$0.00	$124.2
2019	$0.00	$133.6
2020	$0.00	$143.6
2021	$0.00	$154.3
2022	$0.00	$165.9
2023	$0.00	$178.4
2024	$0.00	$191.7
2025	$0.00	$206.1

SIC notes the bill does not require STPF to invest any money. Accordingly, the entire analysis of fiscal impact assumes SIC would choose to invest $100 million in a fund it deems likely to produce no returns.

SIGNIFICANT ISSUES

SIC reports there are reasons to believe the agency would conclude that its fiduciary duties would not permit this type of investment. Specifically, when making any investment, SIC must comply with the Uniform Prudent Investor Act which requires SIC to optimize risk-adjusted returns to best meet the obligations and long-term goals of the STPF. A $100 million allocation categorized by statute as a "non-profit," placed in the sole discretion of a board of non-fiduciary political appointees focused on economic development, at face value, is likely a violation of prudent investor standard.

Currently, SIC has several legislatively-authorized STPF "carve outs" for New Mexico focused / economically-targeted investments (ETIs), including:

- up to 9 percent of the STPF for the New Mexico Private Equity Investment Program;
- up to 6 percent of the STPF for the New Mexico Film Investment Program;
- 1 percent of the STPF automatically allocated to the New Mexico Small Business Investment Corporation (SBIC); and
- up to 20 percent of the STPF for bank certificate of deposit investments with New Mexico Financial Institutions (NMSA 1978, Section 7-27-5.19).

Other statutorily available ETI programs also include:

- up to 20 percent of the STPF for NM Farmers' Home Administration Loans (NMSA 1978, Section 7-27-5.4);
- up to 10 percent of the STPF for Educational Institution Revenue Bonds (NMSA 1978, Section 7-27-5.13); and
- $130 million (about 3 percent) of dollar specific STPF-authorized investments.

In summary, the STPF currently has 69 percent of its funds earmarked for possible ETI investment. Since being reconstituted in 2010, SIC has made a repeated point that it has an extremely limited appetite for differential or "below-market" rate investments, and has brought additional accountability and standards into its investment and due diligence processes.

Analysis from the Economic Development Department (EDD) states that in the past two years, the agency undertook an extensive long-term planning process for a five year strategic plan and the state science and technology plan. There is a consistent message from the business and economic development community that there is a lack of capital to start and grow businesses in the state. In rural areas this problem is a significant deterrent to business and community growth. The Fund could supplement funding programs already available and might encourage more investment by banks in small businesses that are currently unable to receive loans.

The New Mexico Finance Authority (NMFA) reports the bill duplicates some of the duties entrusted to it under the Statewide Economic Development Finance Act. Currently, NMFA operates two loan participation programs that provide below market rate participations, one of which is able to subordinate its security interest to the community bank. Currently, both programs operate under an internal, three-step, independent board approval process before determining participation and eligibility. Both programs operated by NMFA require legislative approval, which is not required by this bill. The Fund in this bill would be similar to the Smart Money Loan Participation program managed by NMFA, which utilizes state funds. Between 2012 and 2014, NMFA dispersed approximately $1.9 million of an available $5.1 million in two loans under the Smart Money Loan Participation program and distributed fifteen loans using the Collateral Support Loan Participation program, dispersing approximately $8.1 million of $13.1 million available for participations.

PERFORMANCE IMPLICATIONS

As with any ETI, there is a strong potential for diminished investment returns in contrast to other more attractive market-rate investments.

EDD has one performance measure associated with getting business development projects funded, and the agency reports this resource could have a positive impact on the department's capacity to meet that target. The longer term effects from the newly available funds could also result in new jobs and investment, supporting the agency's primary mission. There are no metrics provided for job creation, new investment, or revenue or wealth creation, but the bill gives the Board the authority to create policy for the Fund.

ADMINISTRATIVE IMPLICATIONS

EDD notes the administration of a loan participation program requires significant staffing, including loan processing, underwriting, administrative, accounting, and financial control.

The bill requires SIC to "…select an independent third party to examine the development fund at least once every twenty-four months and conduct any investigation of the development fund that may be necessary." This requirement is in addition to audit requirements also required, and also apparently excludes any review by the State Bank Examiner under the Financial Institutions Division of Regulation and Licensing. It is unclear who would bear the burden of the related expenses, either for the audit or the biannual investigation and reporting, either the SIC or the new fund entity.

TECHNICAL ISSUES

EDD and the Attorney General's Office (AGO) note the bill provides for seven board members and provides for appointment of six. AGO notes that it appears those six elect a seventh member to serve as chair but suggests modifying the language to read, "…the board shall elect the seventh member, who shall serve as chair…" to provide more clarity.

The bill limits lender to a "community bank," so micro-lenders such as ACCION, WESST, NM Community Capital, and The Loan Fund would not be eligible to participate. Additionally, the bill allows loans to be made to a resident in addition to a business without requiring the resident to form a business.

The bill provides for up to $100 million to be invested in the Fund from the severance tax permanent fund, but does not require a minimum investment. If SIC invests less than $5 million, the entire investment could be used for start-up costs of the Fund, including the construction of a building and hiring of staff, without any funds being invested in small businesses as intended.

The EDD analysis states an "economic development project" should have more specific language as to what kind of economic growth that will result from the passage of this bill and creation of the Fund, as well as metrics to measure its success and impact on the state. Similarly, the fourth potential use of the Fund is described as "creation and promotion of an environment suitable for the support of start-up and emerging business enterprises within the state." This is vague and should be clarified before any funds are deployed.

OTHER SUBSTANTIVE ISSUES

SIC includes the following issues in its analysis.

> There are several factors behind SIC taking a cautious approach regarding these types of investments. The core reason is the historically poor performance associated with ETIs, and the proven negative impact on the bottom line of STPF performance and financial returns. SIC, LFC, and others have criticized below-benchmark STPF returns resulting from ETI impact on the portfolio. For example:
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> - From 1993-2004, the New Mexico Private Equity Program was focused on job and industry creation rather than return on investment. Annualized investment returns for that period were -18.2 percent, and notably occurred during some of the historically prime years for venture capital investing. Since 2004, when the focus shifted to investment return, program returns have been positive, at about 4.2 percent annually.
> - From 2001-2008, SIC invested in 25 film and television projects, offering zero-interest loans in lieu of profit sharing. While all principal was returned, and certainly the projects brought jobs and spent money in the state, only two films produced profit, and opportunity cost to the STPF was more than $31.5 million (compared to investments conservatively made in U.S. Treasury Bills).
> - In 2007, SIC by statute was required to allocate 1 percent of the STPF to the New Mexico Small Business Investment Corporation (SBIC). Of the $47 million invested by SBIC since 2001, more than $10 million in value has been lost through equity investments made by SBIC in businesses and venture funds.
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> It is noteworthy that the language creating SBIC is similar to that creating the Fund in this bill, and there would be some overlap and duplication in types of loans made by SBIC and the Fund. The most notable difference would be that SBIC only received 1 percent of the STPF in 2007, whereas this Fund seeks more than twice that today.

ALTERNATIVES

EDD suggests an alternative would be to allocate additional funding to the Smart Money Loan Participation program already in place rather than establishing a new fund and process.

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